

**Letter of Findings: 01-20190952
Individual Income Tax
For The Tax Years 2016 and 2017**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Individual failed to demonstrate that income from a closely held C-Corp was repayment of a loan instead of dividend income. The Department's assessment of additional individual income tax is proper and his protest is denied.

ISSUE

I. Income Tax - Distributions from a corporation.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; *Friedrich v. Comm'r*, 925 F.2d 180 (7th Cir. 1991); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E. 2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); [45 IAC 3.1-1-2](#).

Taxpayer protests the Department's income tax assessment.

STATEMENT OF FACTS

Taxpayer owned a majority share in a company that operated as a C-Corp until October 1, 2016, when it became an S-Corp. The Indiana Department of Revenue ("Department") audited Taxpayer for the 2016 and 2017 tax years, finding that he reported insufficient income in each year. The Department therefore issued proposed assessments for additional individual income tax, penalties, and interest. Taxpayer protested these assessments for the 2016 tax year and opted for the Department to make its written decision based on the materials sent in with the protest. Therefore, no administrative hearing was held. This Letter of Findings is written based on the materials in the protest file. Further facts will be supplied as necessary.

I. Income Tax - Distributions from a corporation.

DISCUSSION

The Department's audit determined that the company paid several of Taxpayer's personal expenses, which bore no relation to the economic interest of the company benefits and were conferred with no expectation of repayment. The Department therefore construed these payments as a dividend, meaning they qualified as taxable income. Taxpayer claims that these purchases by the company on his behalf are loan repayments and provided a promissory note memorializing an agreement between the company and Taxpayer.

As a threshold issue, it is the Taxpayers' responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with the federal income and making certain adjustments. IC § 6-3-1-3.5. With regard to corporations and nonresidents, both [45 IAC 3.1-1-2](#) and IC § 6-3-2-2 specifically outline what is income derived from Indiana sources and subject to Indiana income tax, which includes dividends paid to an individual by a company.

Taxpayer argues that the income received from his company in 2016 is a loan repayment and not a dividend. As support, he provides a promissory note expressing the terms of a loan between Taxpayer and his company. The Department's audit determined that this loan is not legitimate because there was no evidence of payment on this loan, even though the promissory note contains specific provisions for annual payments of accrued interest. Therefore, the dispositive question in this case is whether or not the promissory note denotes a *bona fide* loan.

The United States Seventh Circuit Court of Appeals has offered guidance as to what constitutes a *bona fide* loan in *Friedrich v. Comm'r*, 925 F.2d 180, 183 (7th Cir. 1991). There, the Court explained that such a loan must have been the result of arm's length bargaining, which can be shown through a variety of factors. *Id.* These include (1) borrower's intent to repay, (2) borrower's ability to repay, (3) interest rates at or near market rates, (4) clear due dates for repayment, (5) sufficient assets to secure the loan, and (6) evidence of actual payments on the liability. *Id.* at 183-84. No one factor is determinative.

In this case, the irregularities of the promissory note strongly suggest that the company did not intend to repay the Taxpayer. The note is payable on demand and has only a blank payment schedule attached. The company's Statement of Assets, Liabilities, & Equity shows very few payments made on the loan through 2016. This statement also showed little in terms of liquid assets from which the company could make such payments. Furthermore, although the promissory note listed an interest rate, which is compounded annually and due and payable on October 1st of each year, no evidence suggests that interest payments were actually made.

The most critical irregularity of the promissory note, however, is the date it was executed. Although the note is dated January 1, 2014 on the first page, the Certificate of Acknowledgement by the notary shows that the note was executed on November 17, 2016, almost three years after the loan was supposed to have been made and near the end of the tax year at issue. This strongly suggests that the Taxpayer attempted to re-characterize a capital contribution as a loan after he already allowed his company to pay his personal expenses.

The facts and circumstances in this case indicate that the promissory note provided by the Taxpayer is not a *bona fide* loan. Instead, the Taxpayer made a capital contribution and attempted to change its classification after accepting payments from his company. These payments are therefore dividend income, and not repayment of a loan. Taxpayer has not met the burden of proving the proposed assessment incorrect, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

November 22, 2019

Posted: 02/26/2020 by Legislative Services Agency
An [html](#) version of this document.